



REVIEW
OF
DEPARTMENT OF REVENUE
DIVISION OF TAXATION AND COLLECTION
SALES AND USE TAX REFUNDS

**From The Office Of State Auditor
Claire McCaskill**

Report No. 2000-36
May 12, 2000
www.auditor.state.mo.us

AUDIT REPORT



Office Of The
State Auditor Of Missouri
Claire McCaskill

May 2000

The following areas of concern were discovered as a result of a review conducted by our office of the Department of Revenue, Division of Taxation and Collection, Sales and Use Tax Refunds.

Missouri state law authorizes the Department of Revenue (DOR), Division of Taxation, to issue sales and use tax refunds due to an overpaid return, or an audited return. During fiscal year ended June 30, 1999, the department disbursed state sales and use tax refunds, including interest, of approximately \$47,609,000. In addition to refunds, an undetermined amount of credits were applied to under payments of taxes during the fiscal year. Since fiscal year 1990, refund amounts have increased more than 400% as noted in the following table.

SALES AND USE TAX REFUNDS

| FISCAL YEAR | TOTAL REFUNDS |
|-------------|---------------|
| 1990 | \$8,960,000 |
| 1991 | 6,897,000 |
| 1992 | 16,463,000 |
| 1993 | 17,333,000 |
| 1994 | 16,388,000 |
| 1995 | 17,455,000 |
| 1996 | 15,424,000 |
| 1997 | 28,520,000 |
| 1998 | 32,774,000 |
| 1999 | 47,609,000 |

We reviewed sales and use tax refunds totaling approximately \$20,855,000 (including interest) for which there was no indication in the files that the vendor was going to return the tax or interest to the original consumer. We find this especially troubling since a questionable windfall for businesses has been created, and unveils a disincentive to charge taxpayers the correct tax amount.

(over)

YELLOW SHEET

Legislation was introduced in the 1997 legislative session that would have prohibited the refund or credit of sales or use tax erroneously collected by a retailer, unless it was demonstrated that all erroneously collected amounts would be refunded to the person that originally paid the tax. However, this provision was not approved by the General Assembly.

We contacted six contiguous states regarding their policies related to returning refunds to the original customer. Each of these states have regulations, state laws, or policies which provide that refunds must be returned to the original customer.

Based on our review, it appears that much of the increase in refunds during fiscal 1999 was related to country club membership dues, athletic club fees, and changes in rates applicable to food sales, which are relatively new issues.

Approximately \$13,429,000 (37%) of the \$36,550,000 refunds reviewed were related to sales taxes collected and remitted to the Department of Revenue on membership dues paid to country clubs and fees paid to athletic clubs. These refund applications cited various Administrative Hearing Commission (AHC) decisions. The decisions ruled that country clubs were entitled to a refund of sales taxes collected and remitted to the Department of Revenue on dues paid by membership classes which had voting rights in the club, had an ownership interest in the club, and would receive a distribution of the club's assets in the event of dissolution. Other decisions ruled that athletic clubs were entitled to a refund of sales taxes collected and remitted to the department on fees paid by members. These athletic clubs are not considered places of amusement or recreation, but rather fitness centers where the primary purpose is to improve member health and fitness and , therefore, the membership fees are not subject to sales tax.

Several country clubs which collected and remitted sales taxes on membership dues for the tax-exempt members applied for a refund from the Department of Revenue. To determine if the refund request was valid, the department required the clubs to indicate whether the members met the previously noted conditions required by the Administrative Hearing Commission decision. If the clubs indicated all three conditions were met, the refund was processed. However, the department did not require documentation, such as the bylaws, to verify that all three conditions were met. Failure to require adequate documentation reduces assurance that refunds are issued only to clubs which meet the requirements outlined in the Administrative Hearing Commission decision.

Approximately \$2,685,000 (7%) of the \$36,550,000 refunds reviewed were due to changes in sales tax rates applicable to food sales.

Other common reasons noted for refunds included approximately \$5,394,000 for exempt sales, \$4,806,000 related to taxpayer clerical errors, \$3,924,000 for dual operators, and \$2,177,000 pertaining to quarter-monthly filers.

Of the 266 sales and use tax refunds reviewed for fiscal year 1999, at least 76, totaling approximately \$14 million, indicated a consultant was involved in filing the refund request.

REVIEW OF
DEPARTMENT OF REVENUE
DIVISION OF TAXATION AND COLLECTION
SALES AND USE TAX REFUNDS

TABLE OF CONTENTS

| | <u>Page</u> |
|----------------------------------|------------------------------------|
| STATE AUDITOR'S REPORT | 1-3 |
| MANAGEMENT ADVISORY REPORT | 4-9 |
| Summary of Findings | 5 |
| <u>Number</u> | <u>Description</u> |
| 1. | Windfalls to Businesses |
| 2. | Food Tax Refunds |
| 3. | Country Club Membership Dues |
| | 7 8 9 |

STATE AUDITOR'S REPORT



CLAIRE C. McCASKILL
Missouri State Auditor

Honorable Mel Carnahan, Governor
and
Quentin Wilson, Director
Department of Revenue
and
Carol Fischer, Director
Division of Taxation and Collection

We have conducted a review of the Department of Revenue, Division of Taxation and Collection, Sales and Use Tax Refunds. The objectives of this review were to:

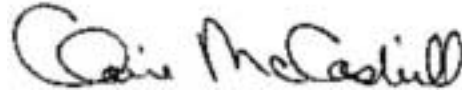
1. Review and evaluate the increase in refunds from fiscal year 1998 to fiscal year 1999.
2. Review and evaluate the basis for refunds paid in fiscal year 1999.
3. Determine whether sales and use tax refunds should have been and were ultimately returned to the original customer.

Our review was made in accordance with applicable generally accepted government auditing standards and included such procedures as we considered necessary in the circumstances. In this regard, we reviewed certain records and documents and interviewed agency personnel. Our review included, but was not necessarily limited to the policies, practices and transactions of fiscal year 1999.

As part of our review, we assessed the department's management controls to the extent we determined necessary to evaluate the specific matters described above and not to provide assurance on those controls. With respect to management controls, we obtained an understanding of the design of relevant policies and procedures and whether they have been placed in operation and we assessed control risk.

Our review was limited to the specific matters described above and was based on selective tests and procedures considered appropriate in the circumstances. Had we performed additional procedures, other information might have come to our attention that would have been included in this report.

The accompanying Management Advisory Report presents our findings and recommendations arising from our review of Sales and Use Tax Refunds.

A handwritten signature in black ink, appearing to read "Claire McCaskill". The signature is fluid and cursive, with the first name "Claire" written in a larger, more prominent script than the last name "McCaskill".

Claire McCaskill
State Auditor

November 19, 1999 (fieldwork completion date)

The following auditors participated in the preparation of this report:

| | |
|---------------------|------------------------|
| Director of Audits: | Kenneth W. Kuster, CPA |
| Audit Manager: | Peggy Schler, CPA |
| In-Charge Auditor: | Christina Davis |
| Audit Staff: | Robyn Lamb |

MANAGEMENT ADVISORY REPORT

REVIEW OF
DEPARTMENT OF REVENUE
DIVISION OF TAXATION AND COLLECTION
SALES AND USE TAX REFUNDS
SUMMARY OF FINDINGS

1. Windfalls to Businesses (pages 7-8)

Sales and use tax refunds totaling approximately \$20,855,000 had no indication in the files that the refunds would be returned to the original customer.

2. Food Tax Refunds (pages 8-9)

Refunds were issued for both over collecting sales tax on food items because the new lower food sales tax rate had not been adopted and for the 3% refund allowed on sales tax collected on qualifying food items.

3. Country Club Membership Dues (pages 9-10)

The Department of Revenue (DOR) did not always require country clubs to provide documentation to verify that the membership dues for which sales tax refunds were issued met the qualifications outlined in an Administrative Hearing Commission (AHC) decision.

REVIEW OF
DEPARTMENT OF REVENUE
DIVISION OF TAXATION AND COLLECTION
SALES AND USE TAX REFUNDS
MANAGEMENT ADVISORY REPORT

Background

Section 144.190, RSMo 1994, authorizes the Department of Revenue (DOR), Division of Taxation, to issue sales and use tax refunds due to an overpaid return, an amended return, or an audited return. During fiscal year ended June 30, 1999, the DOR disbursed sales and use tax refunds, including interest, of approximately, \$47,609,000 (exclusive of local use tax refunds related to the local use tax that was ruled unconstitutional). In addition to refunds, an undetermined amount of credits were applied to under payments of taxes during the fiscal year. Since fiscal year 1990, refund amounts have increased more than 400% as noted in the following table.

| SALES AND USE TAX REFUNDS | | |
|---------------------------|----|---------------|
| FISCAL YEAR | | TOTAL REFUNDS |
| 1990 | \$ | 8,960,000 |
| 1991 | | 6,897,000 |
| 1992 | | 16,463,000 |
| 1993 | | 17,333,000 |
| 1994 | | 16,388,000 |
| 1995 | | 17,455,000 |
| 1996 | | 15,424,000 |
| 1997 | | 28,520,000 |
| 1998 | | 32,774,000 |
| 1999 | | 47,609,000 |

Of the \$47,609,000 sales and use tax refunds issued in fiscal year 1999, we reviewed refunds totaling approximately \$36,550,000 (77%), which included interest payments of approximately \$5,676,000. Interest on refunds is calculated from the date the sales or use taxes were submitted to the DOR.

Based on our review, it appears that much of the increase in refunds during fiscal 1999 was related to country club membership dues, athletic club fees, and food sales, which are relatively new issues.

Approximately \$13,429,000 (37%) of the \$36,550,000 refunds reviewed were related to sales taxes collected and remitted to the DOR on membership dues paid to country clubs and fees paid to athletic clubs. These refund applications cited various Administrative Hearing Commission (AHC) decisions. The

decisions ruled that country clubs were entitled to a refund of sales taxes collected and remitted to DOR on dues paid by membership classes which had voting rights in the club, had an ownership interest in the club, and would receive a distribution of the club's assets in the event of dissolution. Other decisions ruled that athletic clubs were entitled to a refund of sales taxes collected and remitted to DOR on fees paid by members. These athletic clubs are not considered places of amusement or recreation, but rather fitness centers where the primary purpose is to improve member health and fitness and, therefore, the membership fees are not subject to sales tax.

Approximately \$2,685,000 (7%) of the \$36,550,000 refunds reviewed were due to food sales. Effective October 1, 1997, the state sales tax levied on qualifying retail sales of food was reduced from four percent to one percent. State law provided for a refund equal to three percent of all state and local sales and use taxes collected on the qualifying retail sales of food on or after October 1, 1997, and prior to September 30, 1998. The refunds were made without interest, and were only allowed if the taxpayers filed correctly completed claims for refund on or before September 30, 1999.

Other common reasons noted for refunds included approximately \$5,394,000 for exempt sales, \$4,806,000 related to taxpayer clerical errors, \$3,924,000 for dual operators, and \$2,177,000 pertaining to quarter-monthly filers.

Of the 266 sales and use tax refunds we reviewed at least 76, totaling approximately \$14 million, indicated a consultant was involved in filing the refund request.

1.

Windfalls to Businesses

Vendors collect sales and use taxes from their customers and remit the taxes to the Department of Revenue (DOR). Section 144.190, RSMo 1994, authorizes the division to issue sales and use tax refunds due to an overpaid return, an amended return, or an audited return. During fiscal year 1999, the DOR disbursed sales and use tax refunds of approximately \$47,609,000. We reviewed 266 of the refunds issued in fiscal year 1999, totaling approximately \$36,550,000. We noted 128 sales and use tax refunds for various reasons totaling approximately \$20,855,000 (including interest) for which there was no indication in the files that the vendor was going to return the tax or the interest to the original customer. In addition, we reviewed sales and use tax refunds totaling approximately \$2,300,000 for which it was indicated the refunds would be returned to the original customer. There was no documentation that the interest portion of these refunds, totaling approximately \$280,000, would be returned to the original customer; nor was there documentation to ensure, in the majority of the cases, the refund had actually been returned to the customer. Failure by the vendor to return the sales taxes and related interest to the customer results in a windfall for the vendor.

We previously addressed this issue in our audit reports for the two years ended June 30, 1998 and 1994. Legislation was introduced in the 1997 legislative session that would have prohibited the refund or credit of sales or use tax erroneously collected by a retailer, unless it was demonstrated

that all erroneously collected amounts would be refunded to the person that originally paid the tax. However, this provision was not approved by the General Assembly.

We contacted six contiguous states regarding their policies related to returning refunds to the original customer. Each of these states have regulations, state laws, or policies which provide that refunds must be returned to the original customer. Four of the states indicated that if the taxpayers are not the original customers, the taxpayers are required to prove the refunds are distributed to their customers. The other two states indicated that they only give refunds to the original customer.

The division should continue to pursue legislation which would require sales tax refunds and related interest be returned to the original customer. Such a policy would appear to be consistent with the provisions in the contiguous states that we contacted. Legislation should address the situations in which it is not practical or possible to identify the original customer. In these situations it seems reasonable that these monies should be retained by the state and local governments to be used for the benefit of the general public rather than to enrich the vendors that have erroneously collected such taxes.

WE RECOMMEND the department pursue legislation which would require sales tax refunds and related interest be returned to the original customer.

AUDITEE'S RESPONSE

The Department of Revenue (the department) agrees sellers should be required to return sales/use tax refunds to the original purchaser. The department supports legislation including this requirement. However, until such legislation is enacted, the department cannot require a seller requesting a tax refund to provide supporting documentation demonstrating it will pass the refund on to the original purchaser(s).

| |
|----------------------------|
| 2. Food Tax Refunds |
|----------------------------|

Section 144.014, RSMo 1998, reduced the state tax levied on qualifying retail sales of food from four percent to one percent effective October 1, 1997. This section also allowed food vendors to receive a three percent refund on sales and use taxes collected on qualifying retail sales of food for a specified period of time. The section specifically states:

"Any person required to collect and remit the sales or use tax on food pursuant to the provisions of this section shall be entitled to a refund from the general revenue fund equal to three percent of all state and local sales and use taxes collected by such person on or after October 1, 1997, and prior to September 30, 1998, and remitted by such person on or before the date when the same becomes due . . . on the retail sales of food as defined in this section. This refund . . . shall be made without interest. Such refund shall be made

only if such person files a correctly completed claim for refund on or before September 30, 1999, accompanied by such information as the director may require. . ."

We reviewed one case in which the taxpayer requested refunds for the same filing periods for both over collecting and remitting sales taxes at the previous four percent tax rate and for the three percent refund allowed by state law. The portion of the refund related to the three percent refund issue was based on the correct amount of qualifying retail sales.

The law does not specifically address whether the three percent refund should be allowed in the event that the taxpayer failed to implement the tax rate reduction. In the situation noted above, the taxpayer received the compensation for adopting the rate reduction, when in fact, the rate collected from the customer had not been reduced for the filing periods in question.

WE RECOMMEND that in the future if a similar situation occurs the department at least question whether such payments appear reasonable.

AUDITEE'S RESPONSE

The department agrees in general those taxpayers consciously deciding not to collect tax on qualifying food at the statutory reduced state rate should not receive the three percent "administrative" refund. The three percent refund was intended to cover business costs for converting operations to the partial exemption on food. However, in the one case cited in this report, the taxpayer had been collecting tax on some of its food sales at the reduced rate. The business filed amended returns after a review of its records revealed other sales were of qualifying food items. In this isolated instance the taxpayer incurred the administrative burden of complying with the law; therefore, the department concluded there was not sufficient legal basis for denying the three percent refund.

As always, the department will continue to exercise due diligence where the taxpayer is requesting the three percent refund without having incurred the costs associated with complying with the reduced rate on qualifying food items.

3.

Country Club Membership Dues

Country clubs collect sales taxes on membership dues of certain classes of members and remit the taxes to the DOR. Dues for member classes who have voting rights, own equity in the club, and would receive a distribution of the club's assets upon dissolution are tax-exempt. All other membership dues are taxable per AHC decision, *Bogey, Inc. v. Director of Revenue*, No. 96-002209 RV and other related cases. Several country clubs which collected and remitted sales taxes on membership dues for the tax-exempt members applied for a refund from the DOR. To determine if the refund request was valid, the DOR required the clubs to indicate whether the members met the previously noted conditions required by the AHC decision. If the clubs indicated

all three conditions were met, the refund was processed. However, the DOR did not require documentation, such as the bylaws, to verify that all three conditions were met. Failure to require adequate documentation reduces assurance that refunds are issued only to clubs which meet the requirements outlined in the AHC decision.

WE RECOMMEND the department require country clubs requesting refunds for sales taxes on membership dues supply documentation to verify the required conditions exist. In addition, for refunds already paid, the department should review these files to ensure all conditions were met.

AUDITEE'S RESPONSE

The department requires each refund claimant to provide proof that its refund claim conditions are valid and to substantiate the amount claimed. Additionally, all claimants are required to submit amended returns for each period in which a refund is claimed. The department requested country clubs seeking refunds of sales tax paid on membership dues to respond under oath as to whether conditions cited by the court, including the clubs' membership classifications, members' voting rights, ownership rights and rights upon dissolution of the club, were met. In addition, many clubs provided worksheets and other documentation supporting their claims. Bylaws were requested and received if questions arose as to the validity of any of these refund claims. To request bylaws from taxpayers receiving refunds of the sales tax paid on membership dues where there is no evidence the claims were invalid is unduly burdensome on the taxpayer and contrary to the department's commitment to increase voluntary compliance while simplifying and reducing the cost of compliance.

This report is intended for the information of the management of the DOR. However, this report is a matter of public record and its distribution is not limited.

* * * * *